United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

75-7256

B

P/S

United States Court of Appeals
FOR THE SECOND CIRCUIT

S. William Green, Evelyn Green and Cynthia Colin, as Executors of the Estate of Louis A. Green, deceased, and Evelyn Green, individually, and as stockholders of Kirby Lumber Corporation, suing on behalf of themselves and for the benefit of said corporation and for the class of all other stockholders of said corporation similarly situated,

Plaintiffs-Appellants,

against

Santa Fe Industries, Inc., Santa Fe Natural Resources, Inc., Kirby Lumber Corporation, and Morgan Stanley & Co.,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York

UNITED STATES COURT OF APPEALS
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SECOND CIRCUIT

REPLY BRIEF OF APPELLANTS

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3

Table of Contents

AUTHORITIES CITED

<u>NOTE</u>: Emphasis supplied, unless otherwise noted.

REPLY BRIEF OF APPELLANTS*

I

THE DEFENDANTS-APPELLEES HAVE SIMPLY IGNORED THE LAW OF THIS CIRCUIT FOR 10b-5 CASES, ESTABLISHED BY THE DECISION IN SCHOENBAUM AND POPKIN.

(Replies to Points I and II of D. Br. including pp. 1-28. See Pl. Br., Point I, including pp. 4-33).

We stand by our analysis of Schoenbaum (Pl. Br. pp. 8-10) and of Popkin (Pl. Br. pp. 11-12; 20-22). Those decisions establish the law of this Circuit, which defendants-appellees' brief wholly ignores; namely, 10b-5 was violated by the defendants-fiduciaries, because they overreached their stockholder-cestuis in the secretly consummated, freeze-out, security sale-purchase without disclosing the facts in advance to enable the cestuis to prevent the transaction as unfair by state court injunction.

In our main brief (Pl. Br. pp. 21-22) we set forth five factors showing that the merger here in question does not come within the narrow exception recognized by Popkin. Defendants have failed to address themselves to these. Thus, unlike the specific transaction exonerated under 10b-5 in Popkin, (1) the Delaware short form merger statute did not

* "Pl. Br." refers to Plaintiffs-Appellants' main brief. "D. Br." refers to Defendants-Appellees' answering brief.

condition the Kirby merger on shareholder approval; (2) shareholder approval of the Kirby merger was not sought and no prior disclosure of the facts was made to the interested minority; (3) the present claim, necessarily coming after the secret merger was effected, cannot and does not ask for preventive relief, (4) since no prior information was given and the merger was effectuated secretly, the minority did not have the advantage conferred by the federal proxy rules and Rule 10b-5 and so were not placed in a position under state law to enjoin the merger as unfair. (5) Thus the disclosure sought to be compelled by Rule 10b-5 did not occur; hence "it makes sense to concentrate on the impropriety of the conduct itself" as the basis for the 10b-5 violation. Popkin, at 719-720.

Defendants assert (D. Br. p.26) that Delaware does not provide injunctive relief for short-form mergers where the price is unconscionable. All the more reason, then, under Popkin (464 F2d at 719-720) for providing relief under 10b-5.

Defendants assert further (D. Br. p.23) that Delaware law provides for notice after consummation of the merger, not before. All the more need then, under Popkin, for the protection of 10b-5. State provisions, of course, cannot stand in the way of applying 10b-5 in accordance with its protective and remedial purposes (Popkin, at 718).

Defendants (e.g. D. Br., pp. 9, 10, 28) ignore the first and third clauses of 10b-5 which this Court only recently

has insisted must not be read out of the rule. Competitive Associates.

Defendants cite (D. Br., 11, 27-8, 34) the recent decision of the Supreme Court in Blue Chip but that case says nothing adverse to our position; it simply affirms the security purchaser-seller requirement of this Circuit which is undisputedly satisfied in the instant case.

Defendants' entire brief (starting e.g. with p.2) is premised on the assumption, untenable under Schoenbaum and Popkin, that a fiduciary's unconscionable self-deal, not disclosed until after the event, is not a fraud and deception on the cestuis under the first and third clauses of 10b-5. Defendants concede the unconsionableness of the security purchase-sale for purposes of the appeal (D. Br. pp. 2-3), by silence in their brief here they appear to have abandoned their contention below that the complaint does not have the specificity required by FRCP Rule 9(b) (see Pl. Br., pp.27-33), and they concede non-disclosure of the unconscionable purchase-sale until after it was consummated (D. Br., p.5). The inescapable conclusion from Schoenbaum and Popkin is that a 10b-5 violation was committed.

Defendants concede (D. Br. 19) that "a specific fraud" as in Schoenbaum presents a proper claim under Rule 10b-5. Defendants (D. Br. 19) then characterize Schoenbaum as "an insider trading case" in which plaintiffs "alleged that the defendant directors had offered treasury stock to the controlling

shareholder at the then prevailing market price, with knowledge of a major oil discovery which had not yet been publicly disclosed (405 F.2d at 217-8)." Our case is also an "insider trading case". Here, the corporation, at the direction of the controlling shareholder, on July 31, 1974, forced a sale by all the minority shareholders at $150 per share with knowledge that the pro rata value of the physical assets and the fair value of the stock was at least $772 per share (deemed true for purposes of this motion to dismiss) without disclosing those higher values at the time of the forced sale; thus, the $150 per share was clearly an inadequate price for the stock. Therefore here, as in Schoenbaum, all the necessary criteria spelling out fraud were present: control, purchase of shares (or sale in Schoenbaum) at an inadequate price to the disadvantage of the minority, with no disclosure at the time of the forced sale.

Defendants, inconsistently with their analysis of Schoenbaum, apparently contend that it is not a fraud for a corporation to purchase all the minority shares at $150 per share in a forced sale freezeout merger when they conceded (for purposes of the motion) that the value is $772 per share. As held in Schoenbaum, supra, p.215, which is equally applicable here: "A plainer case of fraud would be hard to find."

Defendants also defend on the ground that the fraud on July 31st, 1974 was cured ex post facto when the defendants

on August 1st, 1974 disclosed the inadequate price and the fraud and thereafter gave the stockholders a choice of either accepting the fraudulently low price or seeking an appraisal under Delaware law. We submit this Court has recently made it abundantly clear that appraisal under state law is not an adequate remedy for a violation of the securities laws, see Chris-Craft Ind., Inc., v. Piper Aircraft Corp., F2d (C.A.2, 5/8/75). A fortiori, here, appraisal under Delaware law is not an adequate remedy for the fraud committed in violation of Rule 10b-5. That the appraisal remedy is no substitute for 10b-5 is established law in this Circuit. Pl. Br. p.23.

Defendants misinterpret (D. Br. p.23) Commissioner Sommer's telephone interview. He said nothing to intimate any change in his view (Pl. Br., pp. 25-6) that a fiduciary's self-deal at an unconscionable price without advance disclosure of the facts violates 10b-5.

None of defendants' citations throws any doubt on Schoenbaum or Popkin and on our analysis of the law they lay down for 10b-5. The secret unconscionable fiduciary security purchase-sale was in flagrant violation of 10b-5, not cured by the post-fact disclosure that the cestuis had been taken for a ride under color of a Delaware short merger.

II

THE DEFENDANTS-APPELLEES HAVE IGNORED THE "CAUSAL CONNECTION BETWEEN THE WRONG DONE AND THE HARM SUFFERED"; VIZ. THE UNCONSCIONABLE PRICE INFLICTED BY THE FIDUCIARY ON THE CESTUI.

(Replies to D.Br., pp. 28-30. See Pl. Br. "E", pp. 33-37)

Defendants, as the basis for their contention that no "causal connection" has been alleged "between the wrong done and the harm suffered", assert (D. Br. p.29) that the "only" wrong alleged is non-disclosure in advance of the merger. That is not a correct statement of plaintiffs' claims. The secrecy was part of the wrong which included, as an essential, the unconscionable merger price inflicted on the cestui by the fiduciary in its selfish interest.

Thus the "causal connection between the wrong done and the harm suffered" is self-evident and ignored by defendants: the "wrong done" is the secret unconscionable self-deal and the "harm suffered" is the unconscionable price forced by that self-deal on the cestuis for their securities.

III

THE DEFENDANTS-APPELLEES' DISCUSSION OF DELAWARE LAW ASSUMES, ERRONEOUSLY, THAT THE DELAWARE COURTS DISTINGUISH BETWEEN SHORT AND LONG FORM MERGERS ON THE ISSUE OF UNCONSCIONABLE PRICE AS THE BASIS FOR EQUITABLE RELIEF.*

(Replies to D. Br. pp. 30-34. See Pl. Br., Point III, pp. 39-42).

In Popkin (quoted in Pl. Br. p.40), this Court held that under the applicable Delaware law, the entire fairness

* Contrary to Defendants-Appellees' Brief heading at p.30, the District Court did not address itself to the legal sufficiency of the State law claim.

of the merger would have to pass the careful scrutiny of equity. Defendants seek (D. Br. p.33) to distinguish Popkin's statement on the ground that it referred to a long form merger. But on this issue the Delaware courts refuse to distinguish between long and short form mergers. David J. Greene & Co. v. Schenley Industries, Inc., 281 A.2d 30 (Del. Ch. 1971). There, the Court stated as follows (35):

> In short, I am of the opinion that the rights of plaintiffs and of other minority stockholders of Schenley, viewed in the light of Glen Alden's holding of approximaterly 84% of the common stock of Schenley, are no greater under the present Delaware merger statute here involved (8 Del.C. §251) than under the so-called short-merger statute (8 Del.C. 253). Thus, if plaintiffs and others are not satisfied with the value placed on their shares by Glen Alden, and no fraud or blatant overreaching is demonstrated, their recourse is to an appraisal, Stauffer v. Standard Brand, supra.

And as for the standard of "fraud or blatant overreaching", it is the one referred to in Popkin for Delaware law; thus, quoting Greene further (32):

> Glen Alden concedes that its control of the affairs of Schenley, including the naming of its directors and officers, is such as to call into play the rule applicable in all instances of corporate self-dealing, namely that when officers and directors stand on both sides of a transaction complained of " * * * they bear the burden of establishing its entire fairness, and it (the transaction) must pass the test of careful scrutiny by the courts" Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107, citing Keenan v. Eshleman, 23 Del. Ch. 234, 2 A.2d 904, and Gottlieb v. Heyden Chemical Corp., 33 Del. Ch. 82, 90 A.2d 660

Moreover, defendants pass over in silence the point (Pl. Br. p.42, note) that the forced taking under Delaware authority, without equitable redress for an unconscionable price, would be an unconstitutional taking without due process of law, under North Georgia Finishing, Inc. v. Di-Chem, Inc., ___ U.S.___, 95 S.Ct. 719, 42 L.Ed.2d 751 and cases cited there. In declaring unconstitutional the statute in that case which provided for impounding a bank deposit pendente lite, the Supreme Court held that even a temporary deprivation of "use or possession" "is within the purview of the Due Process Clause" (42 L.Ed.2d, at 757) and pointed to the fatal vice in the statute as follows (id):

> There is no provision for an early hearing at which the creditor would be required to demonstrate at least probable cause for the garnishment.

The very same defect appears in the merger-appraisal statutory procedures, as construed by the defendants-appellees. Defendants, by effecting the merger, deprived the minority of their stock, giving them only the right to seek an appraisal. There was no guarantee of an "early hearing" at which defendants "would be required to demonstrate" at least prima facie that they were offering fair equivalent for the minority stock appropriated by them via the merger forced on the minority against their will. Hence the only way to save the constitutional legality of the merger is to give plaintiffs equitable redress in which the defendants have the burden of proving, at least prima facie, that the self-deal, in which

they have taken their cestui's stock, is not unconscionable as to price and other terms.

IV

THE DEFENDANTS-APPELLEES HAVE FAILED TO REBUT PLAINTIFFS' SHOWING THAT SINCE KIRBY IS THE SURVIVING CORPORATION, A DERIVATIVE ACTION LIES IN ITS BEHALF AS WELL AS A CLASS ACTION FOR ITS MINORITY STOCKHOLDERS.

(Replying to D. Br. pp. 34-37. See Pl. Br., Point IV, pp. 42-46)

Defendants do not attack the class action aspect of the complaint. On the derivative action aspect, they have made no effort to support the District Court's untenable distinction between "old Kirby" and "new Kirby", in light of the undisputed fact that they are one and the same: the "old" Kirby is the surviving corporation, and therefore also the "new" Kirby. Contrary to defendants (D. Br., p.34), the District Court did not hold that plaintiffs are "no longer ... stockholders of Kirby."

Defendants, in asserting that plaintiffs are no longer stockholders (D. Br. pp. 34-35), are begging the question. If the merger is illegal under 10b-5 or under state law and therefore rescinded by court order, then the plaintiffs are still stockholders. To assert they are not stockholders is merely to assume the conclusion, without warrant at the pleading stage, that the merger is legal and hence not rescindable in equity.

Furthermore, defendants pose an unreal dilemma, in saying (D. Br., p.34) that if the plaintiffs are stockholders

they are not sellers. In the class action aspect, pursuant to Vine, the stockholders are (forced) sellers. And in the derivative action aspect, the corporation is the seller of its stock and the purchaser of the absorbed corporation's stock. e.g. Dasho v. Susquehanna Corp., 380 F2d 262 (C.A.7); Simon v. New Haven Board & Carton Co., 250 F.Supp. 297, 298 (D. Conn.), cited in our Brief (Pl.Br. pp. 43-4); and the plaintiffs, for the purposes of the derivative aspect, remain stockholders.

In short, whether the class aspect (stockholders as forced sellers) or the derivative aspect (surviving corporation as seller and buyer and plaintiffs as stockholders suing on its behalf) should be sustained can only be ascertained after trial and not at the pleading stage (Pl. Br., pp. 45-6).

Defendants' assertion (D. Br., pp. 35-6) that a derivative action recovery "would inure to the benefit of the alleged wrongdoers" is incorrect on two counts: rescinding the merger would not benefit the wrongdoers (Pl. Br., p.43); neither would a Pearlman type money judgment which excluded them from its ambit (Pl. Br., p.46). Defendants say (D. Br. p.37) that Delaware courts don't use a Pearlman type judgment, but this Circuit certainly could, at least as to the 10b-5 violation.

As defendants' quotation (D. Br. p.36) from Vine shows, the Court there denied a derivative recovery for a corporation that had been "swallowed whole" by the merger;

but in our case Kirby was not swallowed at all; it is the surviving corporation in the merger and it has swallowed the other corporation. Defendants do not dispute the usual rule that the surviving corporation retains its claims and they may be enforced by derivative action. A derivative remedy of rescission of the merger is by no means meaningless. It may, of course, turn out that that remedy is also available on the class action aspect but there is no reason to choose between them now, Voege (cited in the main brief) 241 F. Supp., at 376, or in that event even later.

V

THE DEFENDANTS-APPELLEES HAVE CONFUSED DIVERSITY JURISDICTION, WITH PENDENT JURISDICTION, OVER THE STATE CLAIM

(Replying to D. Br. pp. 37-40. See Pl. Br., Point II, pp. 37-39)

In Romero, quoted in Pl. Br. pp. 38-39, the Supreme Court held squarely that diversity jurisdiction is not defeated even though a non-diverse party is joined for purposes of federal question jurisdiction and the case must proceed as to the diverse parties under the diversity jurisdiction even where the federal question jurisdiction fails. So the District Court clearly erred in overlooking the rule of Romero which qualified the early case of Strawbridge that it had relied on (Pl. Br., pp. 38-9).

Defendants, seeking to retrieve the situation, confuse diversity jurisdiction with pendent jurisdiction.

As defendants' citations show, if federal question jurisdiction fails at the pleading stage, there is nothing for the state claim to be "pendent" on, so the court declines to consider the state claim under pendent jurisdiction. By contrast, diversity jurisdiction and federal question jurisdiction are independent bases of jurisdiction conferred on the federal courts. Should one lapse the other remains; so under Romero, the non-diverse party is eliminated by dismissal of the federal claim and the state claim proceeds as to the remaining diverse parties under the separate diversity jurisdiction of the federal court.

Of course, we submit that the 10b-5 claim is legally sound and the court therefore has both pendent and diversity jurisdiction over the state claim.

CONCLUSION

ACCORDINGLY, THE JUDGMENT SHOULD BE REVERSED.

Respectfully submitted,

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